VZCZCXRO4785
PP RUEHROV
DE RUEHDS #2816/01 2880452
ZNR UUUUU ZZH
P 140452Z OCT 08
FM AMEMBASSY ADDIS ABABA
TO RUEHC/SECSTATE WASHDC 2349
INFO RUEPADJ/CJTF HOA PRIORITY
RUEAIIA/CIA WASHINGTON DC PRIORITY
RUEKDIA/DIA WASHINGTON DC PRIORITY
RHMFIUU/HQ USCENTCOM MACDILL AFB FL PRIORITY
RUEKJCS/JOINT STAFF WASHINGTON DC PRIORITY
RUCNIAD/IGAD COLLECTIVE

UNCLAS SECTION 01 OF 02 ADDIS ABABA 002816

SIPDIS

E.O. 12958: N/A
TAGS: ECON ETRD EINV EAGR ET
SUBJECT: GOVERNMENT OF ETHIOPIA LIFTS FUEL SUBSIDY

REF: ADDIS 2800

SUMMARY

¶1. (U) The government of Ethiopia's (GoE) Council of Ministers lifted subsides on domestic fuel prices effective October 4. The move came after the International Monetary Fund (IMF) objected to the fuel subsidy before considering a balance of payments loan (reftel). The Council also authorized the Ministry of Trade and Industry (MoTI) to revise domestic retail fuel prices monthly, based upon international prices. Accordingly, on October 4 MOTI increased domestic kerosene prices by 50.4 percent and diesel prices by 39.4 percent. The latest domestic fuel price increases represent one of the single largest fuel price increases in the country's history. While the move to reduce government interventions in this major market is positive, its impact will undoubtedly exacerbate inflationary concerns. End Summary.

BACKGROUND

¶2. (U) In the past several years, MoTI has set Ethiopia's domestic fuel prices quarterly, and utilized a Fuel Stabilization Fund to absorb the shocks of the frequent spikes in world oil prices. However, in spite of the modest adjustments that have occurred, the GoE has spent nearly USD 800 million subsidizing fuel over the last three years. Before the recent drop in fuel prices over the last 3 weeks, an economist at the National Bank of Ethiopia (NBE, Ethiopia's Central Bank) informed EconOff that the GoE was paying as much as USD 50 million every month for a fuel subsidy in order to cushion the local market from the record global rise in fuel costs. On October 3, the Council of Ministers, surprisingly, approved a study on the removal of subsidies on petroleum products. The Council's statement suggested that declining trends in world fuel prices justified a decrease in the national fuel subsidy. The Council also authorized MoTI unilaterally to make monthly revisions of domestic retail fuel prices in order to synchronize more closely with international prices. Effective October 4, MOTI increased domestic retail fuel prices, pushing the retail price of regular petrol (benzene) up by 5.6 percent, kerosene by 50.4 percent, diesel by 39.4 percent, light fuel oil by 31.7 percent and black fuel oil by 26.5 percent. In line with the fuel price increases, the Ministry of Transportation and Communication simultaneously revised taxi and cross country bus fares.

EXPECTED IMPACTS OF THE ADJUSTMENT

¶3. (U) The latest fuel price adjustments are the largest ever made in Ethiopia at any one time. Kerosene, heavily used by the urban poor for cooking has risen in price by 50.4 percent. The 39.4 percent increase in diesel will impact the growing urban working class of Ethiopia who rely on mass transit on a daily basis not to mention the increased transportation costs which will be passed through to consumers broadly. One minor opposition party called for

a reversal of the price hike fearing the move's impact on cost of living and inflation. The Amharic language Reporter newspaper also criticized the move in an October 8 editorial in which it asserted that given Ethiopia is an agrarian economy, the country should have been food self sufficient and should have been exporting wheat to continue subsidizing fuel instead of transferring the subsidy from fuel to wheat. In addition, the GoE's fuel subsidy was contributing to increasing budget deficits, inefficient markets and moreover hampering much-needed poverty reduction spending. The Daily Monitor, a local Addis Ababa newspaper, cited residents' concerns that fuel price hikes would soon be followed by other goods and services increases, thus further compounding the already heightened expectations of future inflation.

FUEL SUBSIDY LIFTED AS GOE TIGHTENS FISCAL BELT
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¶4. (U) The GoE has been forced to cut the fuel subsidy in part because of the IMF's guidance to tighten its fiscal policy in order to rein in inflation and mop up excess liquidity. In addition, soaring current account deficits and the acute lack of foreign exchange in the GoE's coffers has made it increasingly difficult to maintain the current level of fuel imports. Reports from the Ethiopian Petroleum Enterprise indicated that Ethiopia imported 1.88 million tons of fuel last fiscal year (ending July 7, 2008) at a cost of USD 1.6 billion, representing a 17 percent annual increase. The value of merchandise exports during that same period was USD 1.5 billion, falling short of covering fuel bill costs. It remains to be seen whether the move to cut fuel subsidies will restrain fuel imports and change the demands of a booming transport sector that has become very reliant on subsidized fuel. On the other hand, some

experts argue that the price hikes will more than likely affect consumption patterns among urban poor as most cannot afford to buy kerosene at the newly adjusted prices. It is likely that there will be a demand dampening effect for kerosene due to the new policy. The urban poor will likely either be more cautious in using kerosene or move to alternatives like charcoal, fire wood or a combination of both -- each bearing its own environmental impacts. Car owners may stop driving their cars or limit their demand and use public transportation. The question is how significant the change in demand will be and how long will it last. In a July 2008 report, the IMF Executive Board advised the GoE to follow a gradual and cautious removal of fuel price subsidies to abate inflation and address dwindling foreign exchange reserves.

COMMENT

¶5. (U) The reduction of fuel subsidies is expected to impact severely the urban poor and, increasingly, the urban working class. A gradual and selective lifting of the subsidies over a longer period of time would have softened the blow of the recent and dramatic adjustments in fuel prices, but may have also prevented positive IMF consideration of balance of payments support. By making this move now, when oil is selling at $90/barrel, the GoE did buffer the public from bearing the brunt of $150/barrel prices a few weeks ago. It also establishes a mechanism to adjust prices more often now to pass on world price increases to consumers as they occur, rather than imposing another large shock later. It remains to be seen how the urban poor react to this price shock, particularly on kerosene. As the country prepares for the main harvest in December, which is generally energy and fuel intensive, the pressure on domestic fuel costs will only compound already galloping inflation, further deteriorating the cost of living. In addition, the soaring current account deficits and fast depleting foreign exchange reserves will no doubt force the GoE to continue to pass on any future fuel price increase to consumers or to reduce dramatically fuel imports. Post will continue to follow closely these developments. End Comment.

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